

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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FEDERAL HOUSING FINANCE AGENCY, : 11cv6201 (DLC)
: MEMORANDUM
Plaintiff, : OPINION & ORDER
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-v- :
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NOMURA HOLDING AMERICA, INC., et al., :
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Defendants. :
:
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On November 26, 2014, the defendants moved pursuant to Federal Rule of Evidence 702 and Daubert v. Merrill Dow Pharms., Inc., 509 U.S. 579 (1993), to exclude certain expert testimony that plaintiff Federal Housing Finance Agency ("FHFA") intends to offer through two experts, Leonard A. Blum ("Blum") and Peter D. Rubinstein ("Rubinstein"). FHFA had asked Blum to describe how residential mortgage backed securities ("RMBS" or "securitzations") are issued and underwritten and the impact on such issuance and underwriting where the loans underlying the RMBS have collateral characteristics that are inaccurately disclosed or where the loans were defectively originated. To provide his opinions, Blum reviewed and relied upon expert reports issued by other FHFA experts, including John Kilpatrick and Robert Hunter.¹

¹ FHFA also submitted two expert reports from Blum on November 10, 2014, to rebut expert testimony from defendants' due diligence expert. This Opinion does not address the defendants' motion regarding the November 10 Blum reports. Since FHFA's summary judgment motion addressed to the due diligence defense was granted on December 18, 2014, FHFA v. Nomura Holding Am.

FHFA asked Rubinstein to provide an expert opinion concerning the private-label RMBS² securitization process and the financial incentives and functions of the participants in the process during the period of 2005 to 2007. Rubinstein's report describes the mechanics of securitizing residential loans, including how entities like the defendants structured transactions and sourced mortgage loans, how the transactions generated cash flows, the construction of risk structure, and how RMBS were marketed.

Defendants first contend that the two experts should not be permitted to give background testimony about the securitization process and the role of institutional participants in that process without also being able to provide specific testimony linking their descriptions to the defendants. They offer several examples of such testimony. For example, they complain that Blum is offering testimony about Net Trade Value³ and

Inc., --- F. Supp. 3d ---, 2014 WL 7232443, at *40 (S.D.N.Y. Dec. 18, 2014), it is assumed that FHFA is no longer intending to offer testimony from Blum that tracks the opinions contained in his November 10 rebuttal reports. If FHFA does intend to offer any such opinions, it shall promptly identify them to the defendants, and the defendants may renew any portion of this Daubert motion which is affected by that identification.

² Private label RMBS are distinguished from "agency RMBS," which are sold by federal agencies like the GSEs.

³ Blum explains that a Net Trade Value is the difference between "the proceeds received by the bank (and affiliates) from sold

underwriters' financial incentives without informing himself sufficiently about Nomura's profit structure or incentives.⁴ They also complain that Rubinstein offers a description of the ways in which investment banks secured access to a supply of loans without referring to any evidence that Nomura engaged in such practices; that he opines about the conflicts of interest that arise from vertical integration of the participants in the securitization process without tying this testimony to Nomura; and that he offers opinions regarding the extension by underwriters of warehouse lines of credit⁵ to originators without discussing the role of RBS Securities Inc., which acted as an underwriter for four of the RMBS at issue here.

Background evidence regarding the securitization process as well as the role and incentives of the different participants in that process is essential in a trial like this. None of that information is common knowledge. A fact finder, whether a judge

securities, plus the value of any securities retained" and "what the bank paid for the loans plus all marginal expenses of the securitization."

⁴ The defendants explain that all of Nomura's profit on these RMBS transactions was tied to the performance of its residual, that is, its retention of the riskiest tranche of each of the seven RMBS.

⁵ Rubenstein explains that a warehouse line of credit is a "short-term lending facility provided by an investment bank to a mortgage loan originator" that the originator "uses as needed to purchase or originate mortgage loans."

or jury, would depend on an expert with specialized knowledge to provide such critical background information about this highly specialized business activity. Because this testimony is appropriately given through an expert, it is unnecessary to engage further with the parties' separate disputes over the extent to which these two experts have relevant evidence regarding the specific practices and motives of the defendants. Those topics may be explored on cross-examination.

Next, the defendants complain that Blum is offering testimony regarding "scratch-and-dent" loans⁶ and comparing such loans to the seven RMBS at issue here without any showing that they are comparable. Blum principally discusses scratch-and-dent loans to explain why it is important to the market that offering documents for a securitization accurately describe the extent to which the loans in a securitization conform (or not) to an originator's underwriting guidelines. This is relevant, admissible testimony.

Defendants also complain of Blum's conclusion that the securitizations here closely resemble scratch-and-dent securitizations, at least in "certain respects." In giving this opinion, it appears that Blum is largely relying on the analysis

⁶ Blum explains that "scratch-and-dent" loans are those that "(a) violated the underwriting guidelines or program guidelines under which they were intended to have been originated; (b) had document deficiencies; or (c) became delinquent."

of underwriting defects that appears in opinions rendered by FHFA experts Hunter and Kilpatrick, both of whom will be testifying at trial. Defendants may, of course, examine Blum at trial to establish in more detail the extent to which he is relying on the conclusions reached by these other testifying experts. The explicit reliance on the analysis of another testifying expert is entirely proper. If the testimony given by Hunter or Kilpatrick is undercut by their examination at trial or other trial evidence, then the defendants will have an opportunity to demonstrate the extent to which Blum's testimony is also affected.

The defendants next argue that the opinions given by the experts regarding the steps ratings agencies might have taken if accurately informed about the quality of the loans in the RMBS must be excluded because the opinions constitute improper speculation and are not based on any independent analysis. Blum opines, for instance, that where pools of loans backing a securitization had "more risky characteristics than were actually disclosed," the rating agencies "would typically have required greater credit enhancement, such as through larger subordinate tranches." At another point in his report, Blum explains the likely response of credit agencies if presented with a corrected loan tape that discloses higher expected default and loss rates. Blum opines that "rating agencies very

likely may have refused to rate the transactions altogether and/or withdrawn any existing rating."

One of the representations upon which FHFA has brought suit concerns the ratings given by credit rating agencies to the RMBS at issue here. The Amended Complaint alleged that "the ratings for the Securitizations were inflated as a result of Defendants' provision of incorrect data concerning the attributes of the underlying mortgage collateral to the rating agencies, and, as a result, Defendants sold and marketed the GSE Certificates as AAA (or its equivalent) when, in fact, they were not." The Offering Documents represented that the Certificates sold to the GSEs would "not be offered unless they receive[d] ratings at least as high as" AAA or its equivalent from rating agencies, and each Certificate at issue did in fact receive that rating.

Testimony that explains the role of credit agencies in the securitization process and the range of actions they may take when informed either initially or eventually about the compromised quality of the asset pool will be of assistance to the fact-finder. FHFA will be required to show at trial that the defendants provided false descriptions of the loans within the supporting loan groups to the credit agencies and to prove that such misrepresentations affected the ratings given by the agencies to these securities. The defendants' application to strike this testimony is therefore denied.

CONCLUSION

The defendants' November 26, 2014 motion to exclude certain testimony of Leonard Blum and Peter Rubinstein is denied.

SO ORDERED:

Dated: New York, New York
February 13, 2015



DENISE COTE
United States District Judge